No. 15339

In the United States Court of Appeals for the Ninth Circuit

American Trust Company, a Corporation, appellant

v.

James G. Smyth, Collector of Internal Revenue, and United States of America, appellees

ON APPEAL FROM THE JUDGMENT OF THE UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF CALIFORNIA

BRIEF FOR THE APPELLEES

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BRIEF FOR THE APPELLEES

OPINION BELOW

The opinion of the District Court (R. 24-31) is reported in 141 F. Supp. 414.

JURISDICTION

This appeal involves federal income taxes for 1946 in the amount of $570,957.86, plus interest. The taxes in controversy were paid in quarterly installments between March 14, 1947, and December 11, 1947, to James G. Smyth, then Collector of Internal Revenue for the First District of California. (R. 33-34.) Taxpayer filed a claim for refund on November 28, 1949, which

was disallowed by the Commissioner of Internal Revenue on April 25, 1952. (R. 34.) Within the time provided by Section 3772(a)(2), Internal Revenue Code of 1939, and on April 21, 1954, taxpayer filed a complaint in the United States District Court, Northern District of California, Northern Division, for recovery of the taxes paid. (R. 3-16.) Jurisdiction was conferred on the District Court under 28 U.S.C., Section 1346(a)(1). On June 4, 1956, the District Court issued a "Memorandum For Judgment" (R. 24-31) which concluded by stating (R. 31): "Judgment is awarded to defendant, with his costs of suit incurred herein. Counsel for defendants shall present findings, conclusions and a judgment". This was filed on June 5, 1956. Findings of fact, conclusions of law and formal judgment were filed and entered July 30, 1956. (R. 49-50.) On September 14, 1956, taxpayer filed a notice of appeal. (R. 50-51.) Jurisdiction of this Court is invoked under 28 U.S.C., Section 1291.

QUESTION PRESENTED

Article XIV of the Income Tax Convention between the United States and the United Kingdom provides for exemption for residents of the United Kingdom not engaged in trade or business in the United States from a tax on capital gains.

The question is whether an American banking corporation which was trustee under the will of a deceased California resident is exempt from federal taxation imposed on the trust with respect to income attributable to capital gains realized in the United States where the trust income was not currently distributable and where the then living beneficiaries and remaindermen under

the trust (on whom no tax is imposed) were all residents of the United Kingdom.

STATUTES AND OTHER AUTHORITIES INVOLVED

The pertinent statutes and other authorities involved will be found in the Appendix, *infra*.

STATEMENT

The undisputed facts as found by the District Court may be summarized as follows:

Taxpayer was a corporation organized under the laws of California with its principal office in San Francisco, and as such, it was authorized to act and has acted since February 28, 1938, as trustee of a testamentary trust created by one Harry L. Tevis, who died on July 19, 1931. (R. 32-33.)

In 1946 taxpayer sold shares of stock of Kern County Land Company and other securities comprising part of the corpus of the trust and realized gross long-term capital gains of $2,302,733.54, and net long-term capital gains taken into account in the aggregate sum of $1,141,-915.72. Under California law these gains were not distributable to the life beneficiaries of the trust but were required to be and were retained by the taxpayer as trustee as part of the corpus of the trust. (R. 33.)

On March 14, 1947, taxpayer filed a fiduciary income tax return for 1946 in which it reported the gains and paid income taxes thereon in the total sum of $570,957.86, the payments being made in quarterly installments. (R. 33-34.)

On November 28, 1949, taxpayer filed a claim for refund which was on April 25, 1952, disallowed by the Commissioner. (R. 34.)

On July 19, 1931, Harry L. Tevis, late of Santa Clara

County, California, died testate, and on July 26, 1935, his will was admitted to probate in that County. (R. 34-35.) On the date of his death decedent was unmarried. Under his will he bequeathed certain specific legacies in cash to named individuals, created four trusts in equal amounts for each of the four sons of his brother, William S. Tevis, and a fifth trust in equal amount for one Edwin Lee Dunlap. (R. 35.) The rest and residue of all property owned by the decedent at his death was bequeathed in trust one-half to his niece, Florence Fermor-Hesket, and the remaining half to Florence's children born before decedent's death with remainders over (R. 35), for the purposes and the trustee to have the powers as follows (R. 37-38):

> To receive the rents, issues and profits and income of the trust estate, and to pay the net rents, issues, profits and income therefrom in equal shares to the children of my niece Florence Fermor-Hesketh born before my death, or to the survivor or survivors of them during their lives, respectively.
>
> If any of the said children of my said niece, Florence Fermor-Hesketh shall have predeceased me leaving issue living at my death, my said trustee shall forthwith transfer, pay over and deliver to the said issue of each of said children who predeceases me (and there is hereby given, devised and bequeathed to the issue living at my death of each of said children of my niece who shall predecease me) one of as many portions of said corpus of the trust aforesaid as shall be ascertained by adding together the number of children of my said niece living at my death and the number of her

children who predecease me leaving issue living at my death.

If after my death and of the said children of my niece born before my death shall die leaving issue, then there shall be transferred, paid over and delivered to such issue (and in that event there is hereby given, devised and bequeathed to such issue) one of as many parts of the aforesaid trust fund as shall be ascertained by adding together the number of the children of my niece living at my death and the number of her children who predecease me leaving issue living at my death.

If upon the death of the last of the children of my said niece born before my death and after the issue of each of them who left issue either living at my death, or born thereafter, shall have received the portion of the trust fund which it is hereinabove provided shall be delivered to them, there shall be any overplus in the hands of such trustee, said overplus shall be then transferred, paid over and delivered (and, in that event, there is hereby given, devised and bequeathed) to the then living issue of the said children of my said niece in equal shares per capital and not per stirpes.

It was further provided that the word "children" wherever used in the will meant and included only the first generation of direct lineal descendants. The word "issue" wherever used in the will meant and included direct lineal descendants of all generations. (R. 38.)

Taxpayer succeeded the original trustee appointed under the will on February 28, 1938, and since that date has been the duly qualified and acting trustee of the trust just above referred to and has held and possessed

the corporate shares and securities constituting the corpus of the trust including the shares and securities which it sold in 1946. (R. 36.)

Florence Fermor-Hesketh, the decedent's niece had five children all of whom were born prior to the decedent's death, namely Thomas S. Fermor-Hesketh, born October 7, 1910; Louise Fermor-Hesketh Stockdale, born December 15, 1911; Flora Fermor-Hesketh Lawson, born February 23, 1913; Frederick Fermor-Hesketh, born April 18, 1916, and John Brekenridge Fermor-Hesketh, born March 7, 1917. Thomas S. Fermor-Hesketh died on June 21, 1937, without issue. The decedent's niece, Florence Fermor-Hesketh had no child or children who predeceased the decedent and at the time of the decedent's death no child of the niece had predeceased the decedent leaving issue living at the decedent's death. (R. 38-39.)

During the calendar year 1946, the living direct lineal descendants of the children of the niece, Florence Fermor-Hesketh, were the two children of Louise Fermor-Hesketh Stockdale, namely: Ann Louise Stockdale, born May 30, 1938, and Thomas Stockdale, born January 7, 1940; and the three children of Florence Fermor-Hesketh Lawson, namely: John Baring, born August 16, 1934, James Baring, born August 16, 1938 (sons by a former marriage), and Arabella Ann Lawson, born August 14, 1946. All of these direct lineal descendants were and are unmarried. (R. 39.)

Thomas S. Fermor-Hesketh until his death, and each of the four living children of Florence Fermor-Hesketh born prior to decedent's death, and each of the children of such children referred to above, were on the date of decedent's death, and have been continu-

ously since such death residents of the United Kingdom of Great Britain and Ireland, and were not engaged in trade or business in the United States. (R. 39-40.)

The four living children of Florence Fermor-Hesketh and her grandchildren were all born, domiciled in and were subjects and residents of the United Kingdom and since the dates of their respective births they have continued to be domiciled in and are subjects and residents of the United Kingdom and have lived continuously in the United Kingdom. (R. 40.)

Under the terms of the trust, and under the laws of the State of California, the proceeds from the sales of the securities sold by the trustee were required to be and were retained as part of the corpus of the trust and income taxes, if any, arising from such sales, were chargeable against the corpus of the trust. (R. 40.)

The securities were held for more than six months prior to their sale and constituted capital assets. The capital gains realized on such sale amounted to $2,302,-733.54, and after adjustments on account of certain long and short-term capital losses in respect to other securities sold and the application of capital losses carried over from 1945, the net capital gains taken into account from such sales amounted to $1,141,915.72. (R. 41.)

The final decree of distribution by the Superior Court distributing the property under the will of the decedent was entered on July 26, 1935. (R. 36.) The corpus of the trust created under decedent's will particularly referred to above constituted a portion of the property of the decedent distributed to the trustee under that final decree. (R. 41.)

The children and grandchildren of Florence Fermor-

Hesketh were in 1946, and always have been citizens of the United Kingdom of Great Britain and Northern Ireland and never have been citizens of the United States. They have always been residents of the United Kingdom for the purpose of United Kingdom income taxes and were not in 1946, and never have been, residents of the United States for the purposes of the United States income tax. Such children and grandchildren were not and never have been engaged in trade or business in the United States, and they never have had a permanent establishment situated within the United States. (R. 41-42.)

The Fermor-Hesketh family grew out of the union in 1846 of two old English families, namely the Hesketh family and the Fermor family. In 1846 Lady Anna Maria Arabella Fermor married Sir Thomas George Hesketh, and by royal license dated November 8, 1867, Sir Thomas Hesketh and his son, Thomas George were authorized to take the surname of Fermor, and from such date their descendants have borne the name of Fermor-Hesketh. (R. 42.) Florence Fermor Hesketh was born in California on December 31, 1881, and was the daughter of the late John Witherspoon Breckenridge of California. In 1909 she married Sir Thomas Fermor-Hesketh, Baronet, an English citizen and resident in England, and since her marriage she has been a citizen of the United Kingdom and resides therein. Her husband died on July 20, 1944. (R. 42.)

Louise Fermor-Hesketh Stockdale, her daughter, was born in England on December 15, 1911, was educated in England and has lived in England all her life. On July 24, 1937, she married Edmund Villiers Min-

shull Stockdale, a citizen of the United Kingdom and of a British family who is a banker, stock broker, Justice of the Peace and sheriff in the City of London. All of his relatives and his close friends and those of his wife are residents of England and are English people. The two now occupy an estate in Hampshire, comprised of substantial land holdings and their three children are being educated in English schools. (R. 42-43.)

Flora Fermor-Hesketh Lawson was born in England on February 23, 1913, and was educated and lived all her life in England. In 1934 she married Rupert Baring, a citizen of the United Kingdom and their two sons are now being educated at Eton College. They lived in London until 1944 when Flora divorced her husband, who never remarried. Following the divorce, Flora married Commander Arnold Derek Arthur Lawson, a citizen of the United Kingdom who has always resided in England, and she has two daughters by this marriage who were born in London and who have always lived in England. Since their marriage the Lawsons acquired substantial properties and a residence in Buckinghamshire, England. Mr. Lawson was a former solicitor in London but has now retired. Close friends and relatives of the divorced husband and of the Lawsons all reside in England. (R. 43.)

Frederick Fermor-Hesketh was born in England in 1916, has always resided in England and was educated in schools and colleges in England. In 1949 he married Christian Mary McEwen, a citizen of the United Kingdom and a resident of England. The three children by this marriage have always lived in England. (R. 44.)

John Breckenridge Fermor-Hesketh was born in England in 1917, and since his birth has been a citizen

of the United Kingdom and a resident of England. He was educated in schools and colleges in England, and in 1946 he married Patricia Macaskie Cole, an English citizen and resident of England. They have no children. Most of the friends of Mr. and Mrs. John Breckenridge Fermor-Hesketh reside in England. Since 1946 Mr. Fermor-Hesketh some times accompanied by his wife has spent two or three months each year in California looking after certain of his mother's affairs. (R. 44.)

With the exception of John Breckenridge Fermor-Hesketh, the business connections of the members of the Fermor-Hesketh family noted above were almost wholly limited to the United Kingdom and the close friends and members of the Fermor-Hesketh family reside in and are citizens of the United Kingdom. John Breckenridge Fermor-Hesketh has some business interests and friends in California. The bulk of his business and family connections are in England and his close friends reside in and are citizens of the United Kingdom. (R. 44.)

Article XIV of the Income Tax Convention between the United States and the United Kingdom, proclaimed by the President of the United States on July 30, 1946, and effective January 1, 1945 (60 Stat. 1377), provides as follows (R. 40):

> A resident of the United Kingdom not engaged in trade or business in the United States shall be exempt from United States taxes on gains from the sale or exchange of capital assets.

In 1944 and 1945, and at all times thereafter, the United Kingdom income tax and the United Kingdom

surtax were charged upon annual income derived by any person residing in the United Kingdom from any source whatever, and upon annual income derived by any person from sources within the United Kingdom whether or not the resident was a British subject or a resident of the United Kingdom. (R. 45.)

During 1944 and 1945, and at all times thereafter, under the income taxation system in the United Kingdom, a tax was imposed upon income but not upon realized accretions of capital and a resident or nonresident individual, a corporation or a trustee of an express trust who realized gains or profits on the sale of securities or real or other property in the United Kingdom was not chargeable with income tax, excess profits tax or national defense contributions unless what was done was not merely a realization or change in investment but was an act done in what was truly the carrying on of a business. Subject to the foregoing an accretion of capital was not taxable merely because the general capital was invested in the hope and expectation that it would rise in value, and if it did rise in value, the realization on sale did not result in taxable income. (R. 45-46.)

If the sales made by taxpayer as trustee in 1946 had been made by a trustee of a trust created in the United Kingdom, in terms of the trust involved in these proceedings there would have been a realization on and changes in investment within the provisions described in the foregoing paragraph and the gains and profits realized thereon would not have been subject to United Kingdom income tax. (R. 46.)

When the United Kingdom Tax Convention was entered into, under the United Kingdom tax system

there was an income tax (at the standard rate), a surtax, an excess profits tax and a so-called national defense contribution. During 1944 and 1945, under the United Kingdom system of taxation, corporate profits arising under United Kingdom corporations were subject to income tax at a standard rate of 50% and a national defense contribution of 5% unless the excess profits tax on the corporate profits exceeded the national defense contribution and such taxes were paid to the United Kingdom Treasury. When the corporation later declared a dividend to its stockholders it was entitled to deduct therefrom an amount equal to tax at the standard rate on the amount of the dividend. A shareholder or stockholder was not assessable for taxes at the standard rate of the dividend but was required to pay the surtax on the full amount of the dividend (including the amount of the standard tax attributable to the dividend) except that after the effective date of the Income Tax Convention between the United Kingdom and the United States, a resident of the United States was exempted from the United Kingdom surtax in terms of Article VI(2) of the Convention. (R. 46-47.)

During 1944 and 1945, the United Kingdom tax at the standard rate in respect of royalties from mines and other natural resources and rentals from real property, derived from sources within the United Kingdom was imposed on the amount of such royalties and rentals after relevant deductions and allowances at 50%. (R. 47.)

Prior to the United Kingdom Income Tax Convention, credits against the United Kingdom tax on account of foreign taxes paid were not allowed under United Kingdom law except where income arises to a

person resident in the United Kingdom from securities other than Dominion or Colonial securities out of the Kingdom or from stocks or shares or certain other forms of possession other than Dominion or Colonial, out of the Kingdom and chargeable to income tax at the standard rate though not remitted to this Kingdom, a deduction was allowed in computing the amount of chargeable income of any sum which had been paid in respect of income tax in the place where the income had arisen. As a matter of judicial decision it was held that to be so deductible the foreign tax must have been a tax on the income charged to the United Kingdom income tax. This, however, was not to be considered as a credit of tax against tax. (R. 47-48.)

During 1944 and 1945, the United Kingdom did not impose a tax in respect of dividends and interest paid by a United States corporation to a nonresident of the United Kingdom including residents of the United States even though such United States corporations derived income from sources within the United Kingdom and the United Kingdom did not impose taxes upon the accumulated or undistributed profits or surplus of a United States corporation except in the case of certain tax avoidance schemes. (R. 48.)

On the basis of its findings of fact, the District Court concluded that the taxpayer trustee was taxable on the capital gains realized from the sale of the securities and did not qualify for any exemption from taxation on such gains. (R. 48.) Taxpayer has appealed from the judgment of the District Court dismissing the taxpayer's complaint. (R. 50-51.)

SUMMARY OF ARGUMENT

Taxpayer was trustee under the will of a decedent who died a resident of California in 1931. The life beneficiaries and contingent remaindermen were residents of the United Kingdom. In 1946 taxpayer sold securities which were part of the trust corpus and realized capital gains. The proceeds of the sale under California law were not currently distributable but became part of the corpus of the trust, were hence not deductible by the trustee under the Internal Revenue Code, and the capital gains tax therefore was imposed upon the trust and not upon the beneficiaries of the trust.

Taxpayer as trustee was liable for the tax imposed on the trust on the capital gains as income accumulated for future distribution under Section 161 (a)(1), Internal Revenue Code of 1939, and the gains are not exempt under laws of the United Kingdom which only exempts capital gains realized by residents of the United Kingdom.

Section 161 (a)(1) specifically covers the transactions involved and the trust is not relieved from taxation simply because the beneficiaries were residents of the United Kingdom. There is nothing in Article XIV which conflicts with Section 161 (a)(1), or which repeals any of its provisions. The trust is a separate entity for tax purposes and its liability for United States taxes is not affected by the terms of the Convention which applies only so as to exempt resident taxable entities of the United Kingdom from capital gains tax imposed on them by the United States. Here the tax was on the trust and not the nonresident beneficiaries, so Article XIV is inapplicable. This construction is supported by a reading of the Convention as a

whole, and is consistent with the construction uniformly placed on Article XIV by the Treasury Department by Regulations effective ever since 1947. Taxpayer cites no controlling authority to the contrary and the cases it relies upon are all readily distinguishable on their facts.

ARGUMENT

Taxpayer, a Resident American Corporation, as Trustee, Was Liable for United States Taxes Imposed on the Trust for Capital Gains Realized on the Sale of Securities and Held for Future Distribution. No Treaty Exemption Exists Simply Because the Ultimate Remaindermen May Be Residents of Great Britain

Taxpayer was a California corporation engaged in the banking business in the United States and as such was authorized to act as trustee under express trusts. It became trustee under the will of a decedent who died a resident of California in 1931. Upon final distribution under the will of the decedent taxpayer became vested as trustee with the title to securities and in 1946 it sold some of these securities which it had held for more than six months, realizing net taxable capital gains in excess of one million dollars. Taxpayer contends that it is exempt from taxation on these gains because the life beneficiaries and contingent remaindermen of the trust were residents of the United Kingdom. Taxpayer's sole reliance is upon Article XIV of the Income Tax Convention between the United States and the United Kingdom which exempts "residents" of the United Kingdom from United States taxes on capital gains. We contend that the District Court correctly held that the taxpayer here does not fall within those provisions since the trust, on which the tax is imposed, is not a resident of the United Kingdom, as defined in

Article II(1)(g) of the Tax Convention, Appendix, *infra,* but was on the contrary subject to United States taxes under Section 161(a)(1), Internal Revenue Code of 1939, Appendix, *infra.*

1. Article XIV of the Convention, Appendix, *infra,* provides as follows:

> A resident of the United Kingdom not engaged in trade or business in the United States shall be exempt from United States tax on gains from the sale or exchange of capital assets.

As can be readily seen, the crucial issue in the case necessarily centers on a resolution of the question whether the tax here in issue is being imposed on the remaindermen, as the taxpayer contends, or whether it is on the trust, as the District Court held. Since the exemption is one dealing *exclusively* with taxes imposed by the United States, it would seem fairly clear that the treaty intended that any such question should be answered only in relationship to the laws of the United States. We are fortified in this Article II(3) of the Convention, Appendix, *infra,* which states:

> In the application of the provisions of the present Convention by one of the Contracting Parties any term not otherwise defined shall, unless the context otherwise requires, have the meaning which it has under the laws of that Contracting Party relating to the taxes which are the subject of the present Convention.

As we shall show, the income realized in this case is not being taxed to the nonresident remaindermen but, on the contrary, is being taxed a resident trust and the tax is being paid by a domestic trustee. Consequently,

the exemption of Article XIV does not and cannot become applicable.

We turn, accordingly, to a consideration of our income tax, as it relates to trusts, to demonstrate why the conclusion of the lower court is correct.

For many years trusts and estates have been treated under the revenue laws as taxable entities which are separate from their beneficiaries and have been subject to taxation on their income at the same rates imposed upon individuals.[1]

Section 161(a)(1), Internal Revenue Code of 1939, specifically provides that the income tax imposed by Chapter 1 of the Internal Revenue Code of 1939, upon individuals, shall apply to the income of estates or of any kind of property held in trust, including income accumulated for future distribution under terms of a will or trust.

Section 161(b), Internal Revenue Code of 1939, Appendix, *infra,* provides that the tax shall be computed upon the net income of the estate or trust and shall be paid by the fiduciary (here the trustee) with certain exceptions not here applicable. The trustee here is clearly a fiduciary.[2]

Section 162(a), Internal Revenue Code of 1939, Ap-

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[1] See Section 219, Revenue Act of 1918, c. 18, 40 Stat. 1057; Revenue Act of 1921, c. 136, 42 Stat. 227; Revenue Act of 1924, c. 234, 43 Stat. 253; and Revenue Act of 1926, c. 27, 44 Stat. 9; Section 161 Revenue Act of 1928, c. 852, 45 Stat. 781; Revenue Act of 1932, c. 209, 47 Stat. 169; Revenue Act of 1934, c. 277, 48 Stat. 680; Revenue Act of 1936 c. 690, 49 Stat. 1648; Revenue Act of 1938, c. 289, 52 Stat. 447, and the Internal Revenue Code of 1939, and Section 641 of the Internal Revenue Code of 1954.

[2] Section 3797 (a)(6), Internal Revenue Code of 1939, defines the term "fiduciary" to include a trustee or any person acting in any fiduciary capacity for any person.

pendix, *infra,* provides that the net income of an estate or trust shall be computed in the same manner and on the same basis as in the case of an individual, with exceptions here in applicable.

Section 162(b), Internal Revenue Code of 1939, Appendix, *infra,* provides for allowances for additional deductions in computing the net income of an estate or trust for the amount of the income of the estate or trust which is distributable currently by the fiduciary to the legatees, heirs, or beneficiaries, and the amounts so distributable are required to be included in the net income of the legatees, heirs or beneficiaries, whether actually distributed to them or not.

It is well settled that a trust such as the taxpayer here is a separate entity from its beneficiaries and that under Sections 161 and 162, Internal Revenue Code of 1939, as such taxable entity it is required to file returns, report taxable income and pay taxes on a basis similar to that imposed upon individuals provided, however, it may claim some deductions as provided in Section 162, for current distributions to beneficiaries. *Helvering* v. *Butterworth,* 290 U.S. 365; *McCauley* v. *Commissioner,* 44 F. 2d 919 (C.A. 5th); *Anderson* v. *Wilson,* 289 U.S. 20; *Bankers' Trust Co.* v. *Bowers,* 295 Fed. 89 (C.A. 2d); *United States ex rel. Girard Co.* v. *Helvering,* 301 U.S. 540; *Freuler* v. *Helvering,* 291 U.S. 35, 41.

In *Helvering* v. *Butterworth, supra,* the Court stated (p. 369), referring to Section 219 of the Revenue Acts of 1924 and 1926, containing similar provisions to those involved in Section 161:

> The evident general purpose of the statute was to tax in some way the whole income of all trust estates. * * * Certainly, Congress did not intend any

income from a trust should escape taxation unless definitely exempted.

In *McCauley* v. *Commissioner, supra,* the court stated (p. 920):

> Under the Revenue Act of 1913, a trustee was not required to pay a tax upon income derived from trust property, but the Revenue Act of 1916 treated a trustee as a taxable person.

The trustee is a separate taxable entity which does not act as a mere agent in the collection of the income but receives such income as a taxable entity in its own right and not as an agent or conduit for the beneficiaries. *Wittschen* v. *Commissioner,* 5 T. C. 10; *Vandermuhll* v. *Commissioner,* 29 B.T.A. 895, affirmed, 75 F. 2d 656 (C.A.D.C.); *Taylor* v. *Davis,* 110 U. S. 330.

In *Freuler* v. *Helvering, supra,* the Court stated (p. 41) with reference to the provisions of Section 219 (a), Revenue Act of 1921, which contain similar provisions to those in Section 161 (a), Internal Revenue Act of 1939:

> Plainly the section contemplates the taxation of the entire net income of the trust. Plainly, also, the fiduciary, in computing net income, is authorized to make whatever appropriate deductions other taxpayers are allowed by law. The net income ascertained by this operation, and that only, is the taxable income. Thus the fiduciary may be required to accumulate; or on the other hand, he may be under a duty currently to distribute it. If the latter, then the scheme of the Act is to treat the amount so distributable, not as a trustee's income, but as the beneficiary's.

In summary, the trust is an entity separate from the donor or beneficiaries. Where the income is currently distributable, the tax is imposed on the beneficiaries and, under our progressive rate structure the amount of tax imposed on each beneficiary will be determined by the aggregate net income of the beneficiary from all sources. But where the income is to be accumulated, it would be difficult if not impossible to impose the tax on the beneficiary since the exact identity of the beneficiaries who will be able to receive the distribution cannot be known in the year when the trust earns the income and, indeed, as is true here, the year when distribution will be made cannot be known in advance. Consequently, the imposition of a progressive personal income tax on the unknown beneficiary would be impractical. Our scheme of taxation solves this problem by taxing the trust with income which is being accumulated, the rate of the tax being dependent on the net income of the trust as an entity and having no relationship to the current income of the putative beneficiaries. See 6 Mertens, Law of Federal Income Taxation, Sections 36.02, 36.35 and 36.36. Consequently, it is evident that no tax is imposed on any of the beneficiaries with respect to trust income which is being accumulated for future distribution.

Under California law it is clear that the gains from the sales of securities such as here involved were not distributable currently to the beneficiaries but were required to be held as part of the corpus of the trust until its final termination as required by the trust provisions. 3 Deering's California General Laws, Act 8696, Sec. 3, Appendix, *infra; Allen* v. *Commissioner,* 49 F. 2d 716 (C.A. 2d), certiorari denied, 284 U. S. 655; *Old Colony*

Trust Co. v. *Commissioner*, 38 B. T. A. 828; *Fulton's Ex'rs* v. *Commissioner*, 47 F. 2d 536 (C. A. D. C.).

Since the income involved here was required to be accumulated and was not currently distributable, the tax liability imposed by the United States does not fall upon these beneficiaries but upon the trust.[3]

In the case at bar, during the tax year involved, all of the life beneficiaries and contingent remaindermen of the trust were legal residents of the United Kingdom, and they were not engaged in trade or business in the United States through a permanent establishment. But the gain here in contemplation of law was the gain of the trust and the taxability of such gain is clearly governed by Sections 161 and 162, Internal Revenue Code of 1939. Under the foregoing statutory citations it is clear that the capital gains tax here involved was not imposed upon the nonresident beneficiaries and remaindermen, but interest was imposed upon the domestic trust with respect to income earned in this country, and the resident American Trust was responsible for paying the tax. The trustee had control over the trust corpus, sold the securities, realized the gains and had

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[3] The capital gains provisions of the Internal Revenue Code like other tax provisions are applicable to trusts. *Carter* v. *Hoey*, 180 F. 2d 353 (C.A. 2d), affirming 88 F. Supp. 765 (S.D. N.Y.); *In re Rogers' Estate*, 143 F. 2d 695 (C.A. 2d); *Armstrong* v. *Commissioner*, 38 B.T.A. 658; *Weigel* v. *Commissioner*, 96 F. 2d 387 (C.A. 7th). Similarly, capital losses are not deductible by the beneficiaries but must be taken by the trustee. *County National Bank & Trust Co.* v. *Commissioner*, 39 B. T. A. 357, reversed on other grounds, 122 F. 2d 29 (C.A. D.C.); *Peoples National Bank* v. *Commissioner*, 39 B.T.A. 565; *Bisbee* v. *Fahs*, 80 F. Supp. 929 (S.D. Fla.). Losses must be borne by an executor or trustee if realized in course of administration and not by the legatees or beneficiaries even in cases where legal title to the properties disposed of had actually vested in the beneficiaries or legatees. *Jones* v. *Whittington*, 194 F. 2d 812 (C.A. 10th); *Arrott* v. *Heiner*, 92 F. 2d 773 (C.A. 3d).

complete control and dominion over the proceeds. It is the trustee who was required to file tax returns and pay the capital gains tax.[4]

Clearly, since no tax was imposed on or payable by anyone who was a resident of the United Kingdom, Article XIV of the Convention can have no applicability, for an exemption from a United States tax can scarcely have been created in favor of persons who are not subject to a tax and on whom no tax has been imposed.

Section 3797(a)(14), Internal Revenue Code of 1939, Appendix, *infra,* defines a taxpayer as "any person subject to a tax imposed by this title." The trustee here is subject to the capital gains tax and is hence the taxpayer. The trustee's liability for the tax is not determinable by the status of the beneficiaries of the trust for tax purposes or by their equitable title in trust property. This is illustrated in the case of *Lloyd* v. *Delaney,* 86 F. Supp. 1001 (Mass.), affirmed, 181 F. 2d 941 (C.A. 1st), construing Section 421, Internal Revenue Code of 1939, which provided for abatement of income taxes of members of the armed service during the year of their death while on active service. It was held that such provisions did not exempt income collected by

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[4] Under Article II(2)(g) of the Tax Convention, Appendix, *infra,* the term "resident of the United Kingdom" is defined as meaning any person "(other than a citizen of the United States or a United States corporation) who is a resident in the United Kingdom for the purposes of the United Kingdom tax and not resident in the United States for the purpose of United States tax". A corporation is thus only to be regarded as a resident of the United Kingdom if its business is managed and controlled in the United Kingdom. It is clear that taxpayer does not qualify as a resident of the United Kingdom under Article II(1)(g) and hence does not fall under Article XIV.

a trustee of a service man who was killed in action, the trustee having been appointed under the will of the decedent's father, even though the beneficiary bore the brunt of the tax. The case illustrates the point which we make here that the mere fact that trust beneficiaries are exempt will not suffice to exempt the trust itself from the tax. See also *Jones* v. *Whittington*, 194 F. 2d 812 (C.A. 10th).

2. Taxpayer tacitly concedes that the tax here was properly imposed if the capital gains were not exempt under some treaty as provided in Section 22 (b)(7), Internal Revenue Code of 1939, Appendix, *infra*. The contention made by the taxpayer in support of its claims for exemption is that such gains are exempt from taxation under Article XIV of the Tax Convention between the United States and the United Kingdom.

Article XIV provides that a *resident* of the United Kingdom not engaged in trade or business in the United States shall be exempt from United States tax on capital gains. In the first place, Article XIV clearly does not apply here because the taxpayer was not a resident of the United Kingdom. Secondly, the taxpayer was engaged in a trade or business in the United States in the operaion of its bank as trustee, and hence does not fall within the provisions of the article. Thirdly, the taxpayer sold the securities, realized the gain thereon and was required to pay the tax on such gains so that the beneficiaries who were not the taxpayers contemplated by Article XIV could not qualify for exemption, under any circumstances.

The Tax Convention between the United States and the United Kingdom signed on June 6, 1946, and pro-

claimed by the President on July 30, 1946, has the force and effect of federal statutory enactment. A treaty may supersede an Act of Congress just as an Act of Congress may supersede a treaty. *The Cherokee Tobacco,* 11 Wall 616; *Horner* v. *United States,* 143 U.S. 570. But treaties will not be regarded as destroying earlier statutes unless the purpose to abrogate these statutes is clearly expressed and unless the two are clearly incompatible. *Johnson* v. *Browne,* 205 U. S. 309; *Cook* v. *United States,* 288 U. S. 102. The Tax Convention under consideration deals with the exemption of citizens of the United States from British tax and citizens of Great Britain from United States tax on a reciprocal basis. It does not seek to deal with the internal system of taxation by the United States over its own individual citizens, trusts, estates or corporations which are all beyond its scope. Indeed, as we have previously observed, Article II(3) is an expression of policy that the Convention is to be construed in accordance with the laws of the country imposing a tax, except where the context otherwise requires a plain indication that the laws of the United States relative to taxation of trusts were not intended to be disturbed by the Convention. The provisions of the Convention seem clear enough in this regard but their scope and meaning have been also interpreted by the Treasury Regulations. The Treasury Department has prescribed Regulations interpreting the provisions of the Convention including its stated purpose and the capital gains provisions under Article XIV. See T. D. 5569, 1947-2 Cum. Bull. 100.[5]

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[5] These Regulations were promulgated pursuant to Section 62, Internal Revenue Code of 1939, Appendix, *infra,* which provides that the Commissioner with the approval of the Secretary shall

Section 7.514 of T. D. 5569, Appendix, *infra,* states that the primary purposes of the Convention to be accomplished on a reciprocal basis are the avoidance of double taxation upon major items of income derived from sources in one country by persons "resident" in another country and for the exchange of fiscal information complementary to other provisions of the Convention including those relating to avoidance of double taxation. The Convention thus seeks to avoid in certain cases double taxation upon residents of the United States with respect to taxation by the United Kingdom and upon residents of the United Kingdom with respect to taxation of income from sources within the United States. Of course neither situation is involved here since as we have pointed out, the income here is from sources within the United States and in contemplation of law realized by an American taxpayer and is not being taxed to the nonresident beneficiary. The income is not subject to taxation under the laws of the United Kingdom which does not tax the beneficiaries on it.

Section 7.519 (c) of T. D. 5569, Appendix, *infra,* provides that a non-resident alien who resides in the United Kingdom is entitled to exemption from capital tax gains under Article XIV of the Convention only to the extent that such gains are included in his distributive share of income of an estate or trust if he is taxable in the United Kingdom on such income and if

prescribe and publish all needful Rules and Regulations for the enforcement of Chapter 1 of the Internal Revenue Code of 1939 (which includes Section 22(b)(7), Internal Revenue Code of 1939, exempting income to the extent required by treaties) imposing income taxes. Pursuant thereto, the Treasury Department prescribed T. D. 5569, interpreting the provisions of the Convention here involved.

he is not engaged in trade or business in the United States through a permanent establishment. Under those provisions it would follow that if the capital gains had not been required to be held as part of the corpus of the trust and had been currently distributable to and included as income by the beneficiaries which is not the case here, this income to the beneficiaries would be exempt under the Regulations. However, the beneficiaries do not fall within the Regulations under the circumstances here involved because the capital gains are added to corpus of the trust and are not currently distributable. It is clearly the purpose of the Convention only to relieve such income from taxation where it constituted income as distinguished from corpus when received by residents of the United Kingdom.

It is well settled that in construing treaties the constructions placed on them by the Executive Department of the Government are entitled to great weight. Here the Regulations have been in full force and effect since 1947. The executive construction placed on Article XIV is clearly consistent with the article and such Regulations, if not conclusive, are entitled to the greatest weight and importance in considering the question involved. See *Charlton* v. *Kelly,* 229 U. S. 447; *Nielson* v. *Johnson*, 279 U. S. 40; *Ivancevic* v. *Artukovic,* 211 F. 2d 565 (C.A. 9th), certiorari denied, 348 U. S. 818, rehearing denied, 348 U. S. 889.

3. Reduced to its essentials, the taxpayer's argument is that the economic burden of the tax paid by the trust will eventually be borne by the beneficiaries, that, in creating the exemption under Article XIV, the Convention was not concerned with the domestic rules of taxation enacted by the United States, and that the

Convention did intend to create the exemption if the economic burden of the tax falls on a resident of the United Kingdom not engaged in trade or business in the United States. (Br. 17-20, 33-44.) The taxpayer also contends that such a construction of the Convention is necessary to achieve full reciprocity and points to other respects in which reciprocity was achieved by express provisions of the Convention. (Br. 20-32.)

These arguments will scarcely withstand analysis. There is nothing in the Convention or in its background to justify the assumptions that Article XIV intended to disregard the laws of the United States with respect to the entity on which the tax is imposed and to adopt some new concept of exempion which would turn on the probable future status of persons who might ultimately be economically disadvantaged by reason of a tax imposed in early years on another entity.

On the surface of things, the precise opposite would appear to be true. In the first place, Article XIV deals only with a tax imposed by the United States. If, in creating an exemption from that tax, the Convention had intended that the exemption should be applied out of regard to persons whom the United States did not purport to tax, it would be expected that an explicit provision would have been inserted to indicate that such a standard was to be applied. In negotiating the Convention (Br. 20-30) is misplaced. On the contrary, parties were familiar with this segment of the taxing system of the United States relating to the taxation of trusts. Consequently the failure to adopt any express provision which would require a departure from the concepts of the taxing pattern of the United States is a significant indication that none was intended—a conclusion which is reaffirmed by Article II(3).

The taxpayer's discussion of other provisions of the Convention (Br. 20-30) is misplaced. On the contrary, the fact that detailed provisions were required to deal with other problems where the solution of the Convention would collide with the domestic system of taxation of either country is persuasive indication that in Article XIV, where comparable provisions are absent, there was no intent to depart from our basic theory concerning the taxation of trust income being accumulated.

There is nothing to indicate that the Convention intended to adopt the economic burden test being urged by the taxpayer. Aside from the fact that, where federal and state immunities are concerned, the economic burden test has long been discarded.[6] We need only discuss some of the almost impossible difficulties which such a test would have created. These difficulties, and the resulting confusion, indicate only the Convention, even under the most liberal approach, could not be given the meaning urged by the taxpayer.

The precise issue here being raised can only arise in cases where the income is realized and the tax on that income is imposed in *one year* and where the trust property will be distributed to persons in a *future* year to persons whose identity cannot yet be ascertained.[7] And since the personal identity of these beneficiaries cannot be proved in advance, it is obviously impossible to be

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[6] See *Esso Standard Oil Co.* v. *Evans*, 345 U. S. 495; *Graves* v. *N. Y. ex rel. O'Keefe*, 306 U. S. 466; *James* v. *Dravo Contracting Co.*, 302 U. S. 134.

[7] Even though the interest of the beneficiaries is "vested" either for the purpose of the rule against perpetuities or for any other purpose (see taxpayer's discussion (Br. 55-58)), it is obviously impossible to know in advance the identity of the persons who will be in existence at the time when the trust property is distributed.

certain that these persons will be residents of any particular country in the year when the distribution will take place. Did the Convention intend to impose on the courts of this country the burden of determining (a) in what year the distributions will take place; (b) who, precisely, will be the individuals who will receive the distribution, and in what shares; (c) of what country each of these individuals will be a resident; and (d) which of the individuals who will then be a resident of the United Kingdom will not be engaged in trade or business in the United States? And under what standards would this conjecture be based—only when the court can say for a certainty what the future holds (an obvious impossibility), or is the standard one of high probability—of most probability—or of mere possibility? And if any one of these standards is followed, what would be the situation if, at the time of distribution, it turns out that the facts are different and that some of the beneficiaries are not residents of the United Kingdom or are engaged in business in the United States? And what is the exemption where some of the putative beneficiaries are residents of the United Kingdom and others are not? Is the exemption to be allocated and must the court determine what shares will eventually be distributed to each when the relative size of these shares cannot be determined prior to the date of distribution? [8]

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[8] In the present case, it is true that all of these beneficiaries resided in the United Kingdom in 1946. The contingent remaindermen were also residents of the United Kingdom. We may speculate that these remaindermen will continue to reside in the United Kingdom and will be residents and citizens of Great Britain on the date of the termination of the trust, but since they may at any time move to the United States or elsewhere and since any one of them may

These are some of the difficult, perplexing problems which would necessarily attend the taxpayer's "economic burden" argument. The failure of the Convention to offer any guideposts or even to hint at some solution to these difficult problems is, we submit, compelling proof that the Convention never intended to encompass such a theory of tax immunity.

In this respect, it is also pertinent to observe that, with respect to the economic burden ultimately borne by the remaindermen, it would have been almost impossible to have achieved absolute reciprocity between the residents of the countries. Where a British trust accumulates income for future distribution to beneficiaries who turn out to be United States residents in the year of distribution, it is true that the distributable trust corpus will not have been diminished by the previous imposition of a capital gains tax. But there is no assurance under the Convention, and none was intended, that the burden of the British tax on the trust's ordinary income will not have been greater and the impact on the trust property will not have been more extensive than a tax (including one on capital gains) imposed by the United States on a trust in a reciprocal situation. These considerations, too, require rejection of the taxpayer's economic burden approach.

Taxpayer argues (Br. 52-54) that it is an established

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become engaged in business in the United States, all this is mere conjection. Imposition of the tax on the trust may reduce the corpus of the trust and thereby reduce the earning power of the trust so as to decrease the amount reinvestable in new securities held for the benefit of life beneficiaries. It may be inferred that by reason thereof the contingent remaindermen will later become adversely affected because of the reduced value of the corpus, although the extent of the effect or the year in which they would become so affected is speculative.

rule of construction that treaties should be liberally construed and that if any doubt exists a treaty will be construed in favor of rights claimed thereunder.

Taxpayer cites the case of *Geofroy* v. *Riggs,* 133 U. S. 258, 271, in support of its theory that a liberal construction should be given so "as to carry out the apparent intention of the parties to secure equality and reciprocity between them." The Court there stated that words in a treaty should be taken in their ordinary meaning as commonly understood and "not in any artificial or special sense impressed upon them by local law unless such restricted sense is clearly intended."

It is clearly the rule as stated by taxpayer (Br. 52-53) that in construing a doubtful treaty there must be a search for the intent of the parties and to ascertain this intent the treaty must be examined in light of all attendant circumstances to clear up any ambiguity or doubt. *Rocca* v. *Thompson,* 223 U. S. 317, 331. However, courts may not add provisions to a treaty through mere inferences alone to overrule existing laws unless the intent to do so is clearly expressed in the treaty. *Guaranty Trust Co.* v. *United States,* 304 U. S. 126; *Valentine* v. *United States ex rel. Neidecker,* 299 U. S. 5. Ambiguous treaties are construed similar to and according to the intent of the controlling parties as ascertained from an examination of all relevant factors. *Hidalgo County Water Control & Imp. Dist.* v. *Hedrick,* 226 F. 2d 1 (C. A. 5th); *Wright* v. *Henkel,* 190 U. S. 40.

It appears that much the same rules are followed in construing treaties that are used in construing statutes. We submit that the meaning of the Article here involved is so clear on its face that it is unnecessary to go

elsewhere to determine its meaning, but if any doubt existed as to its proper construction, the meaning we contend for here is abundantly clear as evidenced by the scope and purpose of the Convention, the construction placed on it by the Treasury Regulations and by the fact that as disclosed by the history of the Convention, there is not the slightest evidence that the conracting parties ever indicated an intent to repeal or modify any provisions of the United States law dealing with the taxation of American trusts on income derived from sources within the United States or to adopt the taxpayer's economic burden theory.

It is a cardinal rule of construction that—

> the plain, obvious and rational meaning of a statute is always to be preferred to any curious, narrow, hidden sense that nothing but the exigency of a hard case and the ingenuity and study of an acute and powerful intellect would discover.

Lynch v. *Alworth-Stephens Co.,* 267 U. S. 364, 370, quoting with approval from the opinion of the Court of Appeals (294 Fed. 194). See also *DeGanay* v. *Lederer,* 250 U. S. 376.

It is well settled that in construing statutes exceptions are not favored and can never rest upon mere inference or implication alone. *Pacific Co.* v. *Johnson,* 285 U. S. 480; *Heiner* v. *Colonial Trust Co.,* 275 U. S. 232; *United States* v. *Stewart,* 311 U. S. 60.

To adopt taxpayer's theory would be tantamount to holding that there was a repeal of Sections 161 and 162 by implication, a theory which is not favored either in construing treaties or statutes except in cases of posi-

tive irreconcilable repugnancy between the earlier and later enactments. *Graham & Foster* v. *Goodcell,* 282 U. S. 409; *United States* v. *Barnes,* 222 U. S. 513.

Taxpayer admits (Br. 22) that at least 17 of the 24 articles of the treaty are cast in language designed to secure reciprocity, that is exemption from British tax by American subjects, in consideration of a like exemption of the United States tax by British subjects.

There are no articles in the treaty dealing with a pure case of American or British tax action as to their own subjects or exemptions where the taxes only indirectly affect the British subjects where, as here, they may feel the impact of the tax, such as beneficiaries of a taxable trust or estate or stockholder of a taxable corporation. It is true that the United Kingdom imposes no capital gains tax and the United States has by Article XIV extended exemption to British subjects by exempting them from a capital gains tax. Also as pointed out by taxpayer if the capital gains had been distributable currently to the beneficiaries they would be free from the tax because in such case they would be required under Section 162 (b), Internal Revenue Code of 1939, to include the amounts distributed to them in income. But as we have shown, where, as here, the sums are added to corpus, there is no tax on the beneficiaries either in 1946 or even in such years as the corpus is finally distributed on termination of the trust.[9]

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[9] The construction that we contend for here has long been accepted in principle in the construction by the Treasury Department of treatment of trusts for income tax purposes. In an early ruling A. R. N. 37, 2 Cum. Bull. 172 (1920) in construing Section 219 of the Revenue Act of 1918, it was ruled that a trust or estate was a separate taxable entity and that if it was administered in the

In its brief (pp. 37-42) taxpayer argues that the beneficiaries here owned equitable interests in the trust property and that in some cases the revenue laws reach and tax the equitable owners of property on the property income. It is sufficient answer to this contention we believe to say that the revenue laws here clearly tax the trustee and not the beneficiaries on the trust income unless such income is currently distributable to the beneficiaries under Section 162 (b), Internal Revenue Code of 1939, and the statute itself clears up any question as to who bear the imposition of the tax.

Taxpayer in its brief (pp. 44-48) relies as it did below on the case of *Lewenhaupt* v. *Commissioner,* 20 T. C. 151, affirmed *per curiam* 221 F. 2d 227 (C. A. 9th). The District Court considered this authority and regarded it as being readily distinguishable from the case at bar. In that case taxpayer a Swedish Count, a resident and citizen of Sweden, claimed exemption from United States tax on capital gains on sale of real estate in the United States under Article IX of the Convention between Sweden and the United States.

The Commissioner contended that Article IIX when read with Article V of the Convention should be construed as exempting only capital gains from securities and did not apply to real estate. The decision of the Tax Court as affirmed by this Court was in favor of the Commissioner. In reaching the decision and in construing provisions that were claimed to be ambiguous, the Tax Court placed great weight upon the construc-

United States its net income was subject to tax even though its beneficiaries were alien nonresidents, who would not be taxable under American law as it was in effect that time and which exempted income by nonresidents from sources within the United States.

tion placed on the Convention provisions by the Treasury Regulations (citing *Koshland* v. *Helvering*, 228 U. S. 441).

Article V of the Convention there provided that gains from the sale of real estate were taxable only in the contracting state where the property was located, while Article IX provided that gains derived in one of the contracting states from the sale or exchange of "capital assets" by a resident of the other state should be exempt. The Commissioner relied on Article V and the taxpayer relied on Article IX. The Tax Court resolved an apparent literal inconsistency principally by resort to the Regulations which supported the Commissioner's construction in the case. It also relied on the fact that under Article XIV of the Swedish Convention there was a broadly worded savings clause providing that notwithstanding other provisions of the Convention either the United States or Sweden might include in the basis of taxation all items of income taxable under laws of that particular country in which the taxpayers were residents.

Taxpayer here argues that the omission of a similarly broadly worded savings clause from the Convention here involved is significant and indicates an intent to impliedly repeal Sections 161 and 162.

Taxpayer in its brief (p. 44) states that if a similar savings clause had been inserted in the Convention here involved our argument against repeal by implication would perhaps have merit but points out that a similar specific savings clause has appeared in other Conventions all of which it argues indicates an intent that the United States would not retain its taxing rights under Sections 161 and 162.

It is clear that the conventions between various countries and the United States were all arrived at through negotiations on a give or take basis and savings provisions in one or more is no indication of the intent as to others.

In the Report of Senate Sub-Committee dated June 30, 1945, appearing in Senate Executive Report No. 4, 79th Cong., 2d Sess., pp. 11-12, it is stated:

> The conditions encountered in negotiations with foreign countries are found to vary widely as between the respective countries and thus any specific provisions found in one convention may not be found, from the United States standpoint, to be acceptable in a convention with another country. A concession made to a particular country by the United States in a tax convention with such country may not be made in the case of another country in the absence of compensating concessions by such country.

See also Report on Hearing before a Sub-Committee of the Senate Committee on Foreign Relations, 79th Cong., 1st Sess., on Executive D (Convention with Great Britain and Northern Ireland) showing the following:

1. In a memorandum prepared for the Senate Committee on Foreign Relations it is stated (p. 29):

> Examination of every income-tax convention to which the United States is a party will show that it is composed of a series of compromises so far as existing laws and practices of the parties to the Convention are concerned, and the pending Convention with Britain is no exception.

2. A statement of Deputy Commissioner Eldon P. King before the Senate Foreign Relations Committee shows (p. 56):

> There were many compromises in this Convention. * * * Since the provisions of tax conventions represent mutual concessions by both contracting Governments, the present memorandum is directed to that subject.

3. Collin F. Stam, Chief of Staff, Joint Committee on Internal Revenue Taxation, stated (p. 69):

> Any Convention of this sort is pretty well frozen when it comes to us. It is sort of give-and-take arrangement between the two countries.

Though the so-called saving clause appearing in the Swedish Convention does not appear in *haec verba* in the United Kingdom Convention, its provisions are as shown above in substance incorporated in Article II(3). See also Article III(1) and (2) (Br. App. 5a-6a) [10] which provides that United Kingdom Enterprises are not subject to United States tax nor United States enterprises subject to British tax unless they are engaged in trade or business in the taxing countries. The definition of "enterprises" given in Article II(1) (i) and (j) (Br. App. 4a) coincides with residences in that particular country.

Taxpayer also argues that in the *Lewenhaupt* case, *supra,* it is significant that the Regulations were there specifically authorized by the terms of the Convention while here there is no express authorization for the

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[10] "Br. App." references are to the separate bound appendix to taxpayer's brief.

prescribing of the Regulations. As we have shown, the right to prescribe Regulations governing treaties is clearly recognized even in the absence of specific terms of the Convention. See *Factor* v. *Laubenheimer,* 290 U.S. 276. It has always been recognized by the courts that the Executive Branch may interpret treaties and, as we have shown, their construction is entitled to great weight. Furthermore, as we have shown, construction by Regulations of exemption provisions of the revenue laws given by treaties are specifically authorized by Section 62, Internal Revenue Code of 1939, which authorizes Regulations construing all taxing provisions of Chapter 1 of the Internal Revenue Code of 1939.

Taxpayer has cited no controlling authority for the position taken. Its entire argument consists of an attempt to effect repeal of an American taxing act by implication through a strained construction of provisions of a treaty where the plain language of the treaty and the administrative construction are against the construction contended for and where there is nothing in the legislative history and no legal authorities to warrant the construction claimed.

CONCLUSION

The judgment should be affirmed.

Respectfully submitted,

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February, 1957.

APPENDIX

Internal Revenue Code of 1939:

Sec. 22. Gross Income.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including personal service as an officer or employee of a State, or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

(b) *Exclusion from Gross Income.*—The following items shall not be included in gross income and shall be exempt from taxation under this chapter:

* * * * *

(77) *Income exempt under treaty.*—Income of any kind, to the extent required by any treaty obligation of the United States;

* * * * *

(26 U. S. C. 1952 ed., Sec. 22.)

* * * * *

Sec. 62. Rules and Regulations.

The Commissioner, with the approval of the Secretary, shall prescribe and publish all needful

rules and regulations for the enforcement of this chapter.

(26 U. S. C. 1952 ed., Sec. 62.)

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SEC. 117 [As amended by Section 150 (a)(1) of the Revenue Act of 1942, c. 619, 56 Stat. 798]. CAPITAL GAINS AND LOSSES.

(a) *Definitions*—As used in this chapter—

*   *   *   *   *

(4) *Long-term capital gain.*—The term "long-term capital gain" means gain from the sale or exchange of a capital asset held for more than 6 months, if and to the extent such gain is taken into account in computing gross income;

*   *   *   *   *

(26 U. S. C. 1952 ed., Sec. 117.)

*   *   *   *   *

SEC. 161. IMPOSITION OF TAX.

(a) *Application of Tax.*—The taxes imposed by this chapter upon individuals shall apply to the income of estates or of any kind of property held in trust, including—

(1) Income accumulated in trust for the benefit of unborn or unascertained persons or persons with contingent interests, and income accumulated or held for future distribution under the terms of the will or trust;

(2) Income which is to be distributed currently by the fiduciary to the beneficiaries, and income collected by a guardian of any infant

which is to be held or distributed as the court may direct;

(3) Income received by estates of deceased persons during the period of administration or settlement of the estate; and

(4) Income which, in the discretion of the fiduciary, may be either distributed to the beneficiaries, or accumulated.

(b) *Computation and Payment.*—The tax shall be computed upon the net income of the estate or trust, and shall be paid by the fiduciary, except as provided in section 166 (relating to revocable trusts) and section 167 (relating to income for benefit of the grantor).

* * * * *

(26 U. S. C. 1952 ed., Sec. 161.)

Sec. 162. Net Income.

The net income of the estate or trust shall be computed in the same manner and on the same basis as in the case of an individual, except that—

(a) There shall be allowed as a deduction (in lieu of the deduction for charitable, etc., contributions authorized by section 23 (o)) any part of the gross income, without limitations, which pursuant to the terms of the will or deed creating the trust, is during the taxable year paid or permanently set aside for the purposes and in the manner specified in section 23(o), or is to be used exclusively for religious, charitable, scientific, literary, or, educational purposes, or for the prevention of cruelty to children or animals, or for the establishment, acquisition, maintenance or operation of a public cemetery not operated for profit;

(b) [As amended by Sec. 111 (b), Revenue Act of 1942, *supra*]. There shall be allowed as an additional deduction in computing the net income of the estate or trust the amount of the income of the estate or trust for its taxable year which is to be distributed currently by the fiduciary to the legatees, heirs, or beneficiaries, but the amount so allowed as a deduction shall be included in computing the net income of the legatees, heirs, or beneficiaries whether distributed to them or not. As used in this subsection, "income which is to be distributed currently" includes income for the taxable year of the estate or trust which, within the taxable year, becomes payable to the legatee, heir or beneficiary. Any amount allowed as a deduction under this paragraph shall not be allowed as a deduction under subsection (c) of this section in the same or any succeeding taxable year;

*　　*　　*　　*　　*

(26 U. S. C. 1952 ed., Sec. 162.)

Sec. 3797. Definitions.

(a) When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof—

(1) *Person.*—The term "person" shall be construed to mean and include an individual, a trust, estate, partnership, company, or corporation.

*　　*　　*　　*　　*

(14) *Taxpayer.*—The term "taxpayer" means any person subject to a tax imposed by this title.

*　　*　　*　　*　　*

(26 U. S. C. 1952 ed., Sec. 3797.)

3 Deering's California General Laws, Act 8696:

Sec. 3. *What deemed income and principal: Disposition of net income and principal.* * * *

(2) All receipts of money or other propery paid or delivered as the consideration for the sale or other transfer, not a leasing or letting, of property forming a part of the principal, or as a repayment of loans, or in liquidation of the assets of a corporation, or as the proceeds of property taken on eminent domain proceedings where separate awards to tenant and remainderman alone, or otherwise as a refund or replacement or change in form of principal, shall be deemed principal unless otherwise expressly provided in this act. Any profit or loss resulting upon any change in form of principal shall inure to or fall upon principal, except in the case of property referred to and defined by Section 11A, in which case the provisions of Section 11A shall govern.

Convention between the United States of America and the Kingdom respecting double taxation and taxes on income and protocol, 60 Stat. (Part 2) 1377.

By the President of the United States of America
A Proclamation

* * * * *

Article I

(1) The taxes which are the subject of the present Convention are:

(a) In the United States of America:

The federal income taxes, including surtaxes and excess profits taxes (hereinafter referred to as United States tax).

(b) In the United Kingdom of Great Britain and Northern Ireland:

The income tax (including surtax), the excess profits tax and the national defense contribution (hereinafter referred to as the United Kingdom tax).

(2) The present Convention shall also apply to any other taxes of a substantially similar character imposed by either Contracting Party subsequently to the date of signature of the present Convention or by the government of any territory to which the present Convention is extended under Article XXII.

ARTICLE II

(1) In the present Convention, unless the context otherwise requires:

*   *   *   *   *

(g) The term "resident of the United Kingdom" means any person (other than a citizen of the United States or a United States corporation) who is resident in the United Kingdom for the purposes of United Kingdom tax and not resident in the United States for the purposes of United States tax. A corporation is to be regarded as resident in the United Kingdom if its business is managed and controlled in the United Kingdom.

(h) The term "resident of the United States" means any individual who is resident in the United States for the purposes of United States tax and not resident in the United Kingdom for the purposes of United Kingdom tax, and any United States Corporation and any partnership created or organized in or under the laws of the United States, being a corporation or partnership which

is not resident in the United Kingdom for the purposes of United Kingdom tax.

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(3) In the application of the provisions of the present Convention by one of the Contracting Parties any term not otherwise defined shall, unless the context otherwise requires, have the meaning which it has under the laws of that Contracting Party relating to the taxes which are the subject of the present Convention.

ARTICLE XIV

A resident of the United Kingdom not engaged in trade or business in the United States shall be exempt from United States tax on gains from the sale or exchange of capital assets.

T. D. 5569, 1947-2 Cum. Bull. 100:

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Pursuant to section 62 of the Internal Revenue Code, and other provisions of the internal revenue laws, the following regulations, which are designated as sections 7.514 to 7.532, are hereby prescribed and all regulations inconsistent herewith are modified accordingly:

SEC. 7.514. SCOPE OF THE CONVENTION.—The primary purposes of the convention to be accomplished on a reciprocal basis, are to avoid double taxation upon major items of income derived from sources in one country by persons resident in the other country, and to exchange fiscal information complementary to other provisions of the convention, including those relating to avoidance of double taxation.

The specific classes of income from sources within the United States exempt under the convention from

United States tax for taxable years beginning on or after January 1, 1945, are:

(a) Industrial and commercial profits of a United Kingdom enterprise having no permanent establishment in the United States (Article III);

(b) Income derived by a nonresident alien who is a resident of the United Kingdom, or by a United Kingdom corporation, from the operation of ships documented or aircraft registered, under the laws of the United Kingdom (Article V);

(c) Interest and royalties (including film rentals) derived by a nonresident alien who is a resident of the United Kingdom or by a foreign corporation managed and controlled in the United Kingdom if such alien or corporation (1) is subject to United Kingdom tax upon such interest or royalties, and (2) has no permanent establishment in the United States (but such exemption does not apply to interest paid to such foreign corporation controlling the corporation paying such interest) Articles VII and VIII);

(d) Compensation and pensions paid by the United Kingdom to individuals (other than a citizen of the United States who is not also a British subject) for services rendered to the United Kingdom in the discharge of its governmental functions (Article X);

(e) Compensation for personal services derived by a nonresident alien who is a resident of the United Kingdom if (1) such alien is present in the United States for a period or periods not exceeding 183 days during the taxable year, and (2) such services are performed for, or on behalf of, a person resident in the United Kingdom (Article XI);

(f) Pensions (other than pensions paid by the Government of the United States) and life annuities derived by nonresident alien individuals residing in the United Kingdom (Article XII);

(g) Gains from the sale or exchange of capital assets by a nonresident alien who is a resident of the United Kingdom or by a foreign corporation managed and controlled in the United Kingdom, if such alien or corporation has no permanent establishment in the United States (Article XIV);

(h) Dividends and interest paid on or after January 1, 1945, by a corporation organized under the laws of the United Kingdom to a nonresident alien or foreign corporation (Article XV);

(i) Remuneration derived from teaching in the United States for a period of not more than two years by a professor or teacher who is from the territory of the United Kingdom, but who is temporarily present in the United States (Article XVIII);

(j) Remittances from sources within the United Kingdom received in the United States by a nonresident individual who is from the territory of the United Kingdom but who is temporarily present in the United States for the purpose of education, or training, such remittances being for the purpose of his maintenance, education, or training (Article XIX).

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SEC. 7.519. EXEMPTION FROM, OR REDUCTION IN RATE OF, UNITED STATES TAX IN THE CASE OF DIVIDENDS, INTEREST, ROYALTIES, NATURAL RESOURCE ROYALTIES, AND REAL PROPERTY RENTALS.

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(c) *Beneficiaries of an estate or trust.*—A nonresident alien who is a resident of the United Kingdom and who is a beneficiary of a domestic estate or trust shall be entitled to the exemption, or reduction in the rate of tax, as the case may be, provided in Article VI, VII, VIII, IX, and XIV of the convention with respect

to dividends, interest, royalties, natural resource royalties, rentals from real property, and capital gains to the extent such item or items are included in his distributive share of income of such estate or trust if he is taxable in the United Kingdom on such income and is not engaged in trade or business in the United States through a permanent establishment. In such case such beneficiary must, in order to be entitled to the exemption or reduction in the rate of tax, execute Form 1001-UK or Form 1001A-UK (modified to show dividends where applicable) and file such form with the fiduciary of such estate or trust in the United States.

In any case in which dividends, interest, royalties, rents, or the like are derived from United States sources by a United Kingdom estate or trust any beneficiary of such estate or trust who is not a resident of the United Kingdom is not entitled to any exemption under the convention with respect to such income included in his distributive share of the income of the estate or trust.

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SEC. 7.523. CAPITAL GAINS.—Under Article XIV of the convention, when read in association with Article II(2) of the convention, gains from the sale or exchange of capital assets by a nonresident alien individual who is a resident of the United Kingdom or by a foreign corporation managed and controlled in the United Kingdom are, for taxable years beginning on or after January 1, 1945, exempt from Federal income tax unless such alien or corporation has a permanent establishment in the United States. As to what constitutes capital assets, see section 117 Internal Revenue Code. As to what constitutes a permanent establishment see section 7.515 of these regulations. If A, a non resident alien individual who is a resident of the United Kingdom, performs personal services within the

United States during the calendar year 1946 for a domestic employer, he is engaged in trade or business within the United States in such taxable year. (Section 211 (b), Internal Revenue Code.) He carries on in that year no other business activity within the United States other than certain securities transactions upon a domestic stock exchange and maintained no office or other fixed place of business within the United States at any time during such year. A is not subject to Federal income tax upon his capital gains, if any, realized from his securities transactions. Likewise, a foreign corporation managed and controlled in the United Kingdom, selling its products manufactured in the United Kingdom through a resident commission agent or broker in the United States, and having certain securities transactions within the United States as its only business activity therein, is exempt from United States tax upon those capital gains, if any, arising from the securities transactions within the United States.

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